CHAPTER II

EFFECTS ON ECONOMIC INCENTIVES

The Omnibus Budget Reconciliation Act of 1993 substantially increases marginal tax rates on wages and ordinary income from capital (dividends, rent, interest, and business income) for high-income taxpayers. The changes affect incentives to work and save. OBRA-93 also includes provisions that encourage some investments and help some types of business organizations and activities.

CHANGES IN MARGINAL TAX RATES

Marginal tax rates determine how much the government claims on an additional dollar of ordinary taxable income or capital gains. Higher marginal tax rates reduce after-tax returns. As a result, they reduce incentives to work and save and increase incentives to take compensation in the form of tax-free fringe benefits, spend money on tax-deductible goods and services, shift savings to tax-exempt and tax-preferred assets, and defer realizations of capital gains. They also may reduce the amount of voluntary compliance with the tax law.[1] For very high income taxpayers, OBRA-93 increases marginal tax rates substantially on wages and ordinary income from capital, but only slightly on realized capital gains. On average, marginal tax rates remain the same or increase slightly on all three sources of income for all income groups with adjusted gross income (AGI) less than $200,000. Marginal tax rates on wages increase for some low-income taxpayers and decline for others.

Marginal Tax Rates on High-Income Taxpayers

The main provisions in OBRA-93 that change marginal tax rates for high-income taxpayers are the addition of two new tax brackets. OBRA-93 imposes a 36 percent marginal tax rate on joint taxpayers with taxable incomes over $140,000 and single taxpayers with taxable incomes over $115,000. It also imposes a 39.6 percent marginal tax rate on all taxpayers whose taxable incomes are over $250,000. Marginal tax rates for many high-income taxpayers are also increased by the permanent extension of the limitation on itemized deductions (called the Pease provision because it was originally proposed by Representative Donald Pease) and the phaseout of personal exemptions (PEP)

1. For a discussion of some of the behavioral responses to changes in tax policy, see papers in Joel Slemrod, ed., *Do Taxes Matter?* (Cambridge, Mass.: MIT Press, 1990).

in current law. Pease and PEP apply only to taxpayers above certain AGI levels. (These amounts are indexed to changes in the consumer price index.) In 1994, Pease raises the marginal rate for most taxpayers with AGI over $111,800; PEP raises the marginal rate for joint taxpayers with AGI between $167,700 and $292,700 and for single taxpayers with AGI between $111,800 and $236,800. For affected taxpayers in the 31 percent bracket, Pease raises the marginal rate by 0.93 percentage points and PEP raises the marginal rate by 0.61 percentage points per exemption. OBRA-93 also raises the maximum rate under the alternative minimum tax from 24 percent to 28 percent.

In addition to the increases in marginal income tax rates, OBRA-93 raises the marginal tax rate on wages and self-employment income for some high-income taxpayers by eliminating the ceiling on wages ($141,900 in 1994) subject to the hospital insurance (HI) payroll tax. The HI tax rate is currently 1.45 percent on both employers and employees. Assuming that employees bear the full economic burden of the tax, and taking account of the fact that the employer portion of the tax is deductible, eliminating the HI cap raises marginal tax rates on wages for the highest income taxpayers by about 2.3 percentage points.[2]

OBRA-93 did not change the current maximum marginal tax rate on capital gains of 28 percent. Some taxpayers, however, will face higher marginal tax rates on capital gains because of the extension of the Pease provision and the increase in the AMT. The Pease provision raises the marginal tax rate on capital gains from 28 percent to 28.84 percent for taxpayers with AGI over $111,800 who itemize their deductions. The change in the AMT raises the marginal tax rate on capital gains from 24 percent to 28 percent for some taxpayers who are subject to the AMT.

On average, these provisions in OBRA-93 raise marginal tax rates substantially on wages and other income for taxpayers with AGI over $200,000 (see Table 2). Marginal tax rates on wages increase from 30.9 percent to 42.1 percent, and marginal tax rates on other income (mostly dividends, interest, rent, and business income) increase from 30.5 percent to 38.9 percent. The larger change in the marginal tax rate on wages mostly reflects the effects of eliminating the HI cap.

2. The increase in marginal tax rates is less than the sum of the employer and employee tax rates because the 1.45 percent employer portion is not included in income for income tax or payroll tax purposes.

TABLE 2. SIMULATION OF AVERAGE MARGINAL TAX RATES BEFORE AND AFTER OBRA-93, AT 1994 LEVELS OF INCOME (In percent)

Adjusted Gross Income	Before OBRA-93[a]	After OBRA-93[b]
	Marginal Rate on Wages	
Less Than $10,000	16.7	17.6
$10,000-$20,000	30.1	31.2
$20,000-$30,000	30.2	31.7
$30,000-$40,000	31.9	32.0
$40,000-$50,000	31.3	31.5
$50,000-$75,000	31.9	31.9
$75,000-$100,000	31.0	31.0
$100,000-$200,000	31.6	33.9
$200,000 or More	30.9	42.1
Overall	30.7	32.1
	Marginal Rate on Capital Gains	
Less Than $10,000	2.2	2.3
$10,000-$20,000	12.0	12.5
$20,000-$30,000	17.1	18.5
$30,000-$40,000	21.9	23.8
$40,000-$50,000	20.1	22.9
$50,000-$75,000	25.2	25.9
$75,000-$100,000	27.2	27.3
$100,000-$200,000	27.5	28.5
$200,000 or More	27.4	28.3
Overall	24.9	25.8
	Marginal Rate on Other Income	
Less Than $10,000	6.6	8.5
$10,000-$20,000	16.4	17.5
$20,000-$30,000	17.3	18.8
$30,000-$40,000	19.6	19.9
$40,000-$50,000	18.8	19.4
$50,000-$75,000	24.8	25.0
$75,000-$100,000	27.9	28.0
$100,000-$200,000	29.6	31.5
$200,000 or More	30.5	38.9
Overall	22.9	24.7

SOURCE: Congressional Budget Office.

NOTES: Marginal tax rates are calculated on an individual basis using CBO's tax simulation model and are weighted by wages (first panel), capital gains (second panel), and other adjusted gross income (third panel). Marginal rates on wages reflect the combined effects of Social Security payroll and federal income tax rates. The other marginal rates reflect federal income tax only.
OBRA-93 = Omnibus Budget Reconciliation Act of 1993.

a. Before OBRA-93 law is simulated using the fully phased-in law. The personal exemption and itemized deduction limits are not in effect.

b. After OBRA-93 law is simulated using the 1996 values for the earned income tax credit.

By contrast, the marginal tax rate on capital gains for taxpayers with AGI over $200,000 increases only slightly: from 27.4 percent to 28.3 percent. Thus, OBRA-93 has only a small adverse effect on the incentive to realize capital gains. The differential in rates between capital gains and ordinary income from capital increases substantially, however. Before OBRA-93, the differential was about 3 percentage points. OBRA-93 increases it to 11 percentage points. But it remains far below the 30-percentage-point differential for high-income taxpayers that was in effect before the Tax Reform Act of 1986 (TRA-86). This larger differential increases the incentive for high-income taxpayers (those who currently realize most capital gains) to rearrange their investment portfolios in favor of assets that produce capital gains. It also increases the incentive for corporations to retain profits instead of distributing them.

Marginal Tax Rates on Low-Income Taxpayers

OBRA-93 changes marginal tax rates for low-income taxpayers, mainly by expanding the earned income tax credit. The EITC provides a wage subsidy (a negative marginal tax rate) on earnings up to a maximum eligible earnings limit (the subsidy range). The credit remains fixed for earnings between the maximum eligible earnings limit and the income level at which benefits begin to phase out (the maximum credit range). The EITC increases marginal tax rates in the earnings range at which the benefits phase out.

OBRA-93 expands the EITC by increasing the rates of the basic credit and making childless workers with income of up to $9,000 eligible for a reduced credit. When fully put into effect in 1996, the EITC rate under the new law, compared with pre-OBRA-93 law, increases from zero to 7.65 percent for low-income workers with no children, from 23 percent to 34 percent for workers with one child, and from 25 percent to 40 percent for workers with two or more children (see Table 3). The maximum credit (at 1994 levels of income) increases for all three categories of workers, as does the income level at which the credit begins to phase out. The phaseout rate increases for most workers, but declines slightly for workers with one child. The income at which all benefits phase out (and the EITC ceases to raise the marginal tax rate) increases for all three groups of workers.

TABLE 3. PROJECTION OF TAXPAYER RETURNS RECEIVING THE EITC BEFORE AND AFTER OBRA-93, FISCAL YEAR 1994

	Before OBRA-93[a]		After OBRA-93[b]	
	Marginal Rate from EITC (Percent)	Number of Returns (Millions)	Marginal Rate from EITC (Percent)	Number of Returns (Millions)
Phase-In Range				
No children	n.a.	n.a.	-7.65	1.6
One child	-23.00	2.3	-34.00	1.5
Two or more children	-25.00	1.6	-40.00	1.7
Subtotal	n.a.	3.9	n.a.	4.8
Maximum Credit Range				
No children	n.a.	n.a.	0	0.4
One child	0	1.7	0	1.8
Two or more children	0	1.3	0	0.7
Subtotal	n.a.	3.0	n.a.	2.9
Phaseout Range				
No children	n.a.	n.a.	7.65	2.9
One child	16.43	4.0	15.98	4.7
Two or more children	17.86	3.7	21.06	5.3
Subtotal	n.a.	7.6	n.a.	12.9
All Returns with Credit				
No children	n.a.	n.a.	n.a.	5.0
One child	n.a.	8.0	n.a.	8.0
Two or more children	n.a.	6.5	n.a.	7.7
Total	n.a.	14.5	n.a.	20.6

SOURCE: Congressional Budget Office using its Tax Simulation Model.

NOTE: The number of returns with children is based on tax return data. Childless recipients of the earned income tax credit (EITC) are estimated using data from the Current Population Survey. The estimates for childless returns, however, may not be a reliable indicator of who will file and claim this portion of the credit. OBRA-93 = Omnibus Budget Reconciliation Act of 1993; n.a = not applicable.

a. Does not include the effects of the supplemental health insurance or baby credits.

b. Assumes the fully phased-in (1996) credit parameters.

These changes alter marginal tax rates in complicated ways, depending on a taxpayer's wage level and number of children. In most cases, the changes in the EITC reduce the marginal tax rate (increase the subsidy rate) for taxpayers with earnings in the subsidy range. They have no effect on marginal tax rates of taxpayers who remain in the maximum credit range, and they increase the marginal tax rate on earnings for taxpayers in the phaseout range. In addition, some taxpayers' marginal tax rates will change because the changes in parameters move them from one category to another. The changes in the EITC increase the number of taxpayers in both the subsidy range and the phaseout range; the number of returns in the maximum credit range remains approximately the same.

On average, the changes in the EITC increase the marginal tax rate on wages for taxpayers in the bottom three income groups (see Table 2). In each of these three groups with AGI between zero and $30,000, the marginal tax rate on earnings increases by between 1 and 1.5 percentage points. This increase occurs because the higher marginal rate on taxpayers whose benefits are phasing out affects more wage income than the lower marginal tax rate on taxpayers who are receiving additional credits on their last dollar of earnings.[3]

The Congressional Budget Office (CBO) projects that about 21 million returns would be eligible for the EITC under fully phased-in OBRA-93 law at 1994 levels of income (see Table 3). Of these returns, about 5 million would be in the subsidy range, 3 million in the maximum credit range, and 13 million in the phaseout range. The number of taxpayers in the phaseout range at 1994 levels of income increases from 8 million before OBRA-93 to about 13 million under OBRA-93. The combined result of the increased number of taxpayers in the phaseout range and the higher rate at which benefits phase out is an increase in marginal tax rates on wages for many low-income workers.

Marginal Tax Rates on Other Taxpayers

Other taxpayers experience smaller changes in marginal tax rates (see Table 2). Changes in the formula for taxing Social Security benefits increase marginal tax rates for some Social Security recipients in the middle AGI groups. The rate is higher because the increase in the percentage of benefits subject to tax from 50 percent to 85 percent phases in above a defined threshold for AGI. The maximum increase in the marginal tax rate from this provision is 85

3. For taxpayers with AGI below $10,000, marginal tax rates weighted by wage income increase, but marginal tax rates weighted by the number of returns fall. This occurs because more returns are in the subsidy range than in the phaseout range, but the total wage income of taxpayers in the phaseout range is greater than the wage income of taxpayers in the subsidy range.

percent and affects only taxpayers whose modified AGI (AGI plus tax-exempt interest plus half of Social Security benefits) is greater than $44,000 for joint returns and $34,000 for single returns. (For a taxpayer in the 28 percent bracket, this raises the marginal rate on an additional dollar of income other than Social Security to 51.8 percent.) Once income rises enough to make 85 percent of total benefits subject to tax, the marginal rate reverts back to the statutory marginal income tax rate.

Changes in the alternative minimum tax also raise marginal tax rates for some other taxpayers at moderate levels of AGI. These taxpayers, by definition, have moderate levels of AGI only because of tax preferences, however, and therefore actually have high current incomes.

For taxpayers in middle-income ranges (between $30,000 and $75,000), marginal tax rates increase more on capital gains than on wages and other capital income. There are two reasons: first, the elderly, who are affected by the Social Security changes, also have a large share of realized capital gains. Second, taxpayers who have large capital gains are more likely to pay the AMT than taxpayers who receive most of their income from other sources.

EFFECTS ON PRIVATE SAVING

OBRA-93 will increase national saving by reducing the federal deficit. Part of the increase from higher government saving, however, will be offset by lower private saving. CBO's macroeconomic projections assume that private saving declines by about 30 cents for each dollar of reduction in the federal deficit.

Several factors cause this private saving offset to deficit reduction. First, the private sector must pay for federal deficit reduction through higher taxes, lower transfer payments to individuals, or fewer federal subsidies for public goods and services, such as national defense, scientific research, or highways. Higher taxes and lower transfer payments directly reduce the disposable income of individuals and the after-tax profits of corporations. The decline in income reduces both private consumption and saving. People may also save less because they substitute higher private consumption for lower government services.

Second, less federal borrowing may hold interest rates down, thereby increasing the market value of existing wealth. Greater wealth may cause people to consume a larger fraction of current income.

Third, by lowering the return on private saving and the cost of borrowing, lower interest rates also may lower the proportion of income that people save.

Finally, some economists believe that people will consume more (save less) when the government deficit falls because they understand that less government borrowing today reduces their tax liabilities in the future.[4]

Some methods of reducing the federal deficit reduce private saving more than others. Higher taxes and lower transfer payments reduce disposable income directly and could therefore reduce saving more than cuts in federal programs. Tax increases on higher-income people could reduce saving more than across-the-board tax increases because high-income people save a relatively high proportion of their income. Tax increases on income from capital could reduce saving more than tax increases on consumption or wages if the rate of saving varies positively with the after-tax rate of return on saving.

Effect of OBRA-93 Deficit Reduction

Economists have found that fluctuations in the federal deficit between the late 1940s and the mid-1980s have affected private saving. The typical estimate is that each $1 change in the deficit causes private saving to change in the same direction by 30 cents.[5] All of the factors discussed above--changes in after-tax incomes, in before- and after-tax rates of return, and in current government spending and the outlook for future spending and taxes--change private saving.

But the deficit reduction in OBRA-93 may affect saving differently than deficit reductions in the past because a larger portion of the deficit change in OBRA-93 is caused by higher tax rates on high-income individuals. By raising the marginal tax rate that high-income savers face on some forms of income from capital, such as taxable interest, dividends, rents, and business income, the OBRA-93 provisions also lower the after-tax return to saving.

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4. In the extreme, people may perceive that the federal debt they hold is not wealth because it represents a future claim on taxpayers' resources. If all Americans believed this and acted on their belief, changes in private saving would fully offset any change in the federal deficit, leaving national saving unchanged. See Robert J. Barro, *Macroeconomics* (New York: John Wiley and Sons, 1987); and B. Douglas Bernheim, "Ricardian Equivalence: An Evaluation of Theory and Evidence," in Stanley Fischer, ed., *Macroeconomics Annual, 1987* (Cambridge, Mass.: MIT Press, 1987).

5. For evidence on the estimate, see Lawrence H. Summers, "Issues in Saving Policy," in Gerald F. Adams and Susan M. Wachter, eds., *Saving and Capital Formation* (Lexington, Mass.: Lexington Books, D.C. Heath & Co., 1986), p. 65; and Michael J. Boskin, "Concepts and Measures of Federal Deficits and Debt and Their Impact on Economic Activity," in K.J. Arrow and M.J. Boskin, eds., *Economics of Public Debt* (New York: MacMillian, 1988), p. 77.

Decline in Disposable Income. OBRA-93 will raise taxes by about $221 billion between 1994 and 1998. In the absence of behavioral responses, people's after-tax incomes will decline by the same amount.[6] If recent trends continue, the personal saving rate in the United States should remain at about 4.7 percent of disposable income between 1994 and 1998. If people reduce their saving for each dollar of taxes by the average rate of saving from disposable income, the decline in after-tax income resulting from the $44 billion average annual tax increase in OBRA-93 will reduce personal and total private saving in the 1994-1998 period by about $2.1 billion per year.

The reduction in after-tax income will probably have a greater effect on saving than this calculation indicates. The tax increases in OBRA-93 fall heavily on higher-income families. Before behavioral adjustments, the entire net revenue pickup from OBRA-93 comes from families in the top quintile of the income distribution. Available studies suggest that the personal saving rate of the top 20 percent of the population could be as high as 2.4 times the rate for the entire population.[7] Based on this estimate, the decline in after-tax income caused by the tax increase could by itself reduce private saving by an average of $5 billion per year between 1994 and 1998, or about 11 percent of the increase in tax revenue.

Decline in After-Tax Return on Saving. Several provisions of OBRA-93 reduce the after-tax rate of return on saving by raising the tax rate on income from capital. The most important of these provisions are the higher income tax and AMT rates on individuals. Other provisions that reduce the after-tax return, although by a lesser amount, are the increase in the corporate income tax rate, the lower cap on compensation for pensions, the phase-in of the tax on 85

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6. In analyzing the effect of the tax changes on saving, CBO assumes that individuals bear the burden of all taxes, including higher corporate taxes, in the form of lower real after-tax income. CBO does not distinguish between the effects on saving of lower cash income of individuals and the effects of lower retained earnings of corporations.

   There is evidence that people save a higher proportion of income in the form of profits that corporations retain on their behalf than they do of cash dividends or wages. (See, for example, James Poterba, "Tax Policy and Corporate Saving," *Brookings Papers on Economic Activity*, no. 2, 1987.) This means that the composition of tax increases between corporate income taxes and individual income taxes can affect the amount by which private saving changes. But the tax changes in OBRA-93 will probably have little net effect on retained earnings of corporations. The higher corporate tax rate will reduce retained earnings, but the expanded investment incentives and the increase in the differential between marginal tax rates on dividends and capital gains will increase retained earnings. Because the net effect on retained earnings is minor, analyzing the tax change as if it all appears at the level of the individual taxpayer should have little impact on the estimate of how much saving will fall.

7. See Barry Bosworth, Gary Burtless, and John Sabelhaus, "The Decline in Saving: Evidence from Household Surveys," *Brookings Papers on Economic Activity*, no. 1 (1991); and John Sabelhaus, "What Is the Distributional Burden of Taxing Consumption?" *National Tax Journal*, vol. 46, no. 3 (September 1993), p. 336.

percent of Social Security benefits, and the extension of the top rates under the estate tax.

The increases in income tax rates reduce the after-tax return on saving the most for taxpayers with taxable incomes in excess of $250,000. For these taxpayers, the marginal tax rate increases from 31 percent to 40.79 percent on ordinary capital income (dividends, taxable interest, rents, and unincorporated business income.)[8] This rate increase reduces the after-tax return by 14.2 percent.[9] But the increases in the marginal tax rate affect only a minority of taxpayers in the top quintile. For the top quintile as a whole, the average marginal tax rate on ordinary capital income increases from 28.7 percent to 31.7 percent. This reduces the after-tax return in the top quintile by 4.2 percent. Other provisions also reduce the after-tax return for some taxpayers, but only slightly.

The tax rate increases in OBRA-93 do not apply to untaxed sources of income, such as interest from tax-exempt bonds or the return from household assets (owner-occupied homes and consumer durables). In addition, the tax rate on capital gain income increases only slightly.[10] Income from these tax-exempt assets and capital gains represents between one-half and two-thirds of the capital income of high-income taxpayers.[11] Because the rate increases do not apply to large portions of their income from capital, the average reduction in the after-tax rate of return on all investments for taxpayers in the top quintile is at most 2 percent. The after-tax return declines by much less for other taxpayers.

A lower after-tax return on saving has two offsetting effects on people's rates of saving. On the one hand, the lower return means that less future consumption is gained by giving up a dollar of current consumption. Thus, people substitute current for future consumption by saving less (the substitution effect). On the other hand, the lower return also means that people who are

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8. The new top rate is 1.03 times the top statutory rate of 39.6 percent because of the limitation on itemized deductions.

9. The percentage reduction in the after-tax return is 100 times [(1 - 0.4079)-(1 - 0.31)]/(1 - 0.31) = 14.19 percent.

10. Returns from tax-preferred assets may decline because the higher marginal tax rates will encourage high-income families to purchase more of them. But these portfolio shifts also raise pretax returns on taxable assets.

11. The capital income shares are estimated from the assets held by families with over $50,000 of income in 1989, and on total flow of funds data from the 1980-1988 period on revaluations of assets. For family assets in 1989 see Arthur Kennickell and Janice Shack-Marquez, "Changes in Family Finances from 1983 to 1989: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin* (January 1992), pp.1-18.

net savers are less well off during their lifetimes because whatever saving they do earns less. As a result, people tend to cushion the decline in future consumption by saving more now (the wealth effect).

Studies of rates of saving for the entire U.S. population do not establish conclusively the relative size of the substitution and wealth effects. Many studies find that the two effects cancel out each other, implying that the higher tax rates that OBRA-93 imposes on capital income will not change private saving rates. Other studies find that the substitution effect is larger than the wealth effect, which implies that the higher tax rates of OBRA-93 will reduce private saving. For example, one frequently cited study finds that a 1 percent reduction in the after-tax rate of return reduces the private saving rate by 0.4 percent.[12] This means that if the after-tax rate of return falls from 5 percent to 4.5 percent--a 10 percent decline--the rate of saving will fall by 4 percent, from 4.7 percent to about 4.5 percent. Combining this savings response with the estimated 2 percent reduction in the after-tax return for taxpayers in the top quintile, the Congressional Budget Office estimates that OBRA-93 will reduce the rate of saving of the top quintile by at most 0.8 percent.

CBO projects that total personal saving will be about $240 billion a year between 1994 and 1998.[13] Recent research finds that saving of the top quintile is about equal to total saving.[14] Thus, saving of the top quintile will average about $240 billion a year between 1994 and 1998. The estimate of an 0.8 percent decline in the saving rate of the top quintile amounts to an overall decline in personal saving of about $2 billion per year--less than 5 percent of the increase in tax revenues. CBO expects total private saving to decline by a similar amount because, as noted above, retained earnings of corporations are likely to change only slightly.

Overall Effect on Private Saving: Summary

The tax rate increases in OBRA-93 can reduce private saving in two ways: by reducing total after-tax income and by lowering the after-tax rate of return on

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12. Michael J. Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, vol. 86, no. 3 (1978), pp. S3-S27. This estimate is for the entire population; responses for different groups within the population could differ widely.

13. Congressional Budget Office, *The Economic and Budget Outlook: An Update* (September 1993). The figures in this paper are derived by adjusting calendar year totals for the 1996-1998 period to compute projections of saving by fiscal year.

14. Sabelhaus, "What Is the Distributional Burden of Taxing Consumption?" p. 336. Sabelhaus estimates that total saving in the bottom four quintiles is approximately zero. Positive saving by households in the fourth quintile is about equal to negative saving by households in the bottom three quintiles.

saving. The lower after-tax income could reduce private saving by as much as $5 billion; the lower after-tax return by up to almost $2 billion. Studies by economists, however, do not establish conclusively that the rate of return effect reduces saving at all. Thus, the two effects could reduce private saving by between $5 billion and $7 billion a year--which amounts to between 11 percent and 16 percent of the revenue pickup.

Studies by economists based on historical data predict that people will reduce their saving by about 30 cents for each dollar of deficit reduction. This reduction is about twice as large as the reductions derived from the direct effects of higher tax rates on after-tax incomes and after-tax rates of return. The lower deficits that come from raising taxes can also reduce saving through three other channels. First, the lower federal borrowing can increase the market value of existing wealth by lowering interest rates. As noted above, an increase in wealth may reduce the proportion of income that people save. Second, the lower interest rates also reduce the return to an additional dollar of saving. Third, people may save less if they perceive that the lower federal deficits increase their wealth. This could happen if lower federal deficits today make expected future tax liabilities less than they would otherwise be.

In conclusion, the tax increases in OBRA-93 will reduce private saving, but by much less than the increase in federal revenue. Therefore, if the higher revenues are applied to deficit reduction, national saving will increase.

EFFECTS ON BUSINESS ORGANIZATIONS AND INDUSTRIES

OBRA-93 will influence the economic behavior of businesses in several ways, including effects on the choice of organizational form and on the amount of investment and its allocation among industries.

By increasing the top individual statutory tax rate more than the top corporate rate, OBRA-93 increases the incentive to operate a business in the corporate form. By raising tax rates, extending certain tax preferences, and enacting some new ones, OBRA-93 encourages some investments and discourages others. A number of these provisions are aimed at small businesses. Other provisions of OBRA-93 affect international transactions and limit business deductions.

Top Statutory Tax Rates and the Choice of Business Organization Form

Subchapter C of the Internal Revenue Code imposes a separate tax on corporate profits. Because corporations may not deduct dividends from taxable profits (and individuals may not claim credit for corporate taxes paid on their behalf), shareholders face two levels of income tax on corporate profits--the corporate income tax and the individual income tax on dividend income. By contrast, owners of partnerships pay only the individual income tax. The income of partnerships is allocated directly to them and included in their adjusted gross income.

Corporations that have 35 or fewer shareholders and meet certain other tests may elect to be taxed as Subchapter S corporations. As with partnerships, S corporations do not pay the separate corporate tax; their owners pay individual income tax on their share of the income of the business.

Business behavior after the Tax Reform Act of 1986 indicates that firms are sensitive to statutory tax rates when they choose their business form. TRA-86 reduced the top individual marginal rate below the top corporate rate for the first time (see Table 4). After TRA-86, the share of total corporate profits earned by S corporations increased from 3.1 percent in 1986 to 7.4 percent in 1987, 8.1 percent in 1988, and 8.3 percent in 1989.[15]

OBRA-93 reverses this effect of TRA-86 by raising the top individual tax rate above the top corporate rate. This makes it more advantageous for businesses that retain their earnings to choose the corporate form. Business owners who operate as noncorporate businesses (partnerships and S corporations) now face a maximum statutory tax rate of 39.6 percent, compared with 31 percent in 1991 and 1992. By contrast, OBRA-93 increases the tax rate by 1 percentage point for C corporations. The rate changes reduce the share of pretax profit that owners receive after federal taxes (the after-tax share) from 69 percent to 60.4 percent for owners of partnerships and S corporations and from 66 percent to 65 percent for owners of C corporations that retain their profits. Thus, before OBRA-93 the after-tax share was about 5 percent higher for partnerships and S corporations than for C corporations.

15. For evidence of how TRA-86 affected the growth of S corporations, see Jeffrey Mackie-Mason and Roger Gordon, "Taxes and the Choice of Organizational Form," Working Paper No. 3781 (National Bureau of Economic Research, Cambridge, Mass., 1991); and Susan Nelson, "S Corporations Since the Tax Reform Act of 1986" in National Tax Association, *Proceedings of the Eighty-Fourth Annual Conference on Taxation, 1991* (Columbus, Ohio: National Tax Association--Tax Institute of America, 1992).

TABLE 4. TOP STATUTORY INCOME TAX RATES ON BUSINESS INCOME
(In percent)

	1982-1986	1988-1990	1991-1992	1993 and After
Top Statutory Tax Rate on Owners of:				
Noncorporate Business[a]	50.0	28.0	31.0	39.6
Corporate Business with All Earnings Retained	46.0	34.0	34.0	35.0
Corporate Business with All Earnings Distributed[a]	73.0	52.5	54.5	60.7
After-Tax Income as a Share of Profits in:				
Noncorporate Business[a]	50.0	72.0	69.0	60.4
Corporate Business with All Earnings Retained	54.0	66.0	66.0	65.0
Corporate Business with All Earnings Distributed[a]	27.0	47.5	45.5	39.3

SOURCE: Congressional Budget Office.

a. Assumes top individual income tax rate.

After OBRA-93, the after-tax share is about 8 percent higher for C corporations than for partnerships and S corporations.[16] It is likely, therefore, that OBRA-93 will induce some businesses to switch back to the C corporate form.

16. Owners of closely-held C corporations must pay additional tax in the future to remove retained profits from the corporation: individual income tax if they distribute the profits to themselves and capital gains tax if they sell their share in the business. Because of the benefit of deferral, however, the present value of this additional tax may be small enough to keep the total tax burden on income in C corporations lower than the tax on income in S corporations. By contrast, under pre-OBRA-93 law, the tax burden on C corporations was always higher.

Large businesses generally operate as C corporations and in many cases distribute a significant portion of their annual income as dividends to shareholders. Because shareholders of these corporations pay higher marginal tax rates on their dividend income, OBRA-93 does not substantially improve the relative position of large corporations. At the extreme, the changes in tax rates would make C corporations that distribute all their income slightly worse off compared with S corporations, when the owners of both types of firms are in the top tax bracket (see Table 4). The provisions of OBRA-93 reduce the after-tax share of partnerships and S corporations by 12.5 percent (from 69 percent to 60.4 percent) but reduce the after-tax share of a C corporation that distributes all its income to owners in the top marginal rate bracket by an even larger 13.6 percent (from 45.5 percent to 39.3 percent.)[17]

Therefore, by increasing individual income tax rates, OBRA-93 increases the incentive for C corporations to retain instead of distribute earnings. For corporations with shareholders in the top bracket, the ratio of the after-tax share from retaining profits to the share from distributing them increases from 1.45 (66/45.5) to 1.65 (65/39.3). For corporations that distribute all their profits, OBRA-93 slightly increases the incentive to finance investment with debt instead of equity capital. For corporations that retain all their profits, it reduces the incentive for debt finance.

Investment Incentives

OBRA-93 is likely to affect the pattern of investment more than its overall level. The 1-percentage-point increase in the corporate income tax raises the cost of corporate capital slightly. This discourages investment, but not much. Three provisions encourage selected forms of corporate investment, while one discourages other forms. The incentives differ among types of firms.

The increase in the amount of investment that can be deducted immediately encourages spending on equipment by small firms (see below); extension of the research and experimentation credit through the middle of 1995 temporarily encourages investment by firms that create intangible capital such as patents and copyrights; and changes to the corporate AMT encourage investment in equipment by firms--mostly larger ones--that pay tax under the AMT or expect to pay it in the future. The lengthening of the depreciation lifetime for nonresidential structures from 31.5 years to 39 years discourages firms not paying the AMT from investing in such properties.

17. Between 1989 and 1992, U.S. corporations paid dividends of about two-thirds of their after-tax profits. For a corporation with this typical payout ratio, OBRA-93 reduces the after-tax share by 8.6 percent.